

reassessment of a set of policies that have been needlessly burdensome to long-distance customers, local telephone companies, long-distance carriers, and the general economy for more than three decades. Long-distance rates have been kept artificially high in order to defray the costs of connecting subscribers to the network, thereby allowing local dial-tone rates to be kept artificially low. This policy, in turn, has sharply reduced long-distance calling and, as a result, consumer and producer welfare. Now, in the wake of the 1996 Telecommunications Act, the Commission has commendably proposed to change direction. But this change in direction cannot ignore the central purpose for creating interstate access charges in the first place -- namely, the recovery of the incumbent local exchange carriers' (LECs') costs that have been assigned to the interstate jurisdiction. Nor should it compromise another important policy goal -- the stimulus for economic efficiency and network investment -- by interfering with the operation of the Commission's LEC price-cap regime that has worked so well for the past seven years.

3. Regulatory commissions in general and the Commission in particular have been quite cognizant of the adverse incentive effects of cost-based regulation. As a result, the Commission shifted from cost-based regulation to price caps for dominant interexchange carriers in 1989 and for the LECs in 1990. Under these price-cap regimes, carriers have been limited to annual rate increases that may not exceed the rate of inflation less a productivity "offset." The price-cap regime for the LECs' interstate services remains in place as a central part of the Commission's policy of regulating the LECs' interstate rates, and it has satisfied the Commission's objectives of inducing improvements in carrier efficiency and lowering rates. The

Commission should therefore be wary of any approach to changing access charges that compromises the efficiency-enhancing effects of the established price-cap regime.

4. In this proceeding, the Commission proposes to restructure the LECs' carrier access charges in a direction more consistent with cost causation and to reverse earlier decisions to recover a substantial share of nontraffic sensitive network costs from usage-based rates. The current policy of structuring interstate access rates creates large losses in economic welfare by keeping the fixed monthly cost of an access line low while recovering a large share of costs from long-distance services that are far more price elastic in demand.² The Commission invites comments on various proposals to redress these inefficiencies, but some of the proposals would needlessly reverse the beneficial effects of price caps while simultaneously opening the possibility that LECs would not be permitted to recover those costs that were assigned to the interstate jurisdiction decades ago. If the Commission is to fulfill its responsibility to permit carriers to recover the costs of regulated services from regulated rates, it must ensure that the resulting rates cover the LECs' cost of conducting their regulated activities. Otherwise, the LECs will be understandably reluctant to invest in costly new facilities whose costs they may not be able to recover.

² The requirements for quasi-efficient regulatory rates under production conditions in which full costs cannot be recovered through incremental-cost pricing were described in William J. Baumol and David F. Bradford, "Optimal Departures from Marginal-Cost Pricing," The American Economic Review, June 1970, pp. 265-283. These requirements have been extended to telecommunications regulation in a number of different scholarly publications. Among the earliest of the papers applying them to the U.S. telecommunications sector is Jeffrey Rohlfs, "Economically-Efficient Bell System Pricing," Bell Laboratories, Economic Discussion Paper No. 138, January 1979.

5. A Commission decision to require incumbent LECs to restructure their method of charging for interstate access does not require that the Commission abandon its decision to decouple rates from movements in costs under the price-cap regime. The Commission should not now return to a cost-based regulatory system in which the rates for recovering various components of the costs assigned to the interstate jurisdiction are based upon engineering estimates or any other measure of costs. Nor should the Commission lose sight of the fundamental purpose for which access charges were erected in the first place, namely, the recovery of LEC costs assigned to the interstate jurisdiction.

6. In short, the Commission should ensure that the restructuring of access rates does not risk the sacrifice of two important goals -- cost recovery and future productive efficiency -- in pursuing the gains from potentially more efficient access charges. This risk is unnecessary, for the Commission can move toward a more efficient pricing structure without sacrificing these other important objectives. But the Commission should not require that the various components of these charges reflect only forward-looking engineering estimates of carrier costs because such a decision would compromise the goal of cost recovery and would represent a renunciation of the Commission's decision to use price caps as an incentive-based regulatory mechanism. Instead, the Commission should rely upon competition and the continued application of price caps to drive the LECs' interstate rates down over time.

Recovery of Nontraffic-Sensitive Costs

7. The Commission's Notice correctly concludes that the recovery of part of the nontraffic sensitive costs of local loops through carrier common line (CCL) charges is inefficient

because these charges do not reflect "...the manner in which the loop costs are incurred."³ They never have. These costs should be recovered through a flat charge per line. Perhaps the best approach for doing so is simply to levy a charge on interstate long-distance carriers on the basis of their pre-subscribed lines. This charge could be passed forward by the interexchange carriers to their customers through various pricing options, including on a flat monthly per-line basis, thereby satisfying the criterion of cost causation.

8. Changing the structure of access charges to reflect cost causation would also have the desirable effect of lowering per-minute access rates, which, if passed on to consumers, would stimulate greater use of the network. The resulting increase in interexchange traffic could generate billions of dollars of additional long-distance revenues per year and a large increase in economic welfare.

9. A minor problem with recovering the nontraffic sensitive loop costs through a charge on interexchange carriers based on pre-subscribed lines is that long-distance customers are increasingly able to use dial-around procedures to access any of a number of carriers. A flat monthly CCL rate levied on the pre-subscribed carrier could be passed on by that carrier to the customer as a commensurate monthly charge even if the customer used other carriers for most of its outbound calls. Regardless, the burden of the charge would still fall on the subscriber on a flat, non-usage basis. The charge would recover the loop costs efficiently because it would not be levied on incremental calls and it would be competitively neutral.⁴

³ Notice at 58.

⁴ The only exception to this conclusion would be that subscribers could avoid the charge by not choosing to subscribe to a long-distance carrier, a rather unlikely possibility for

The Market-Based Approach Versus the "Prescriptive" Approach

10. The costs now recovered through interstate access charges are carrier costs that have been incurred in the course of delivering local exchange and exchange-access services. These costs are necessarily different from the costs that would be incurred if the network were built with today's technology for today's geographical distribution of lines and today's demand for interexchange services. As a result of technical progress and unanticipated demographic changes, the actual incurred costs may well be above those that would have been incurred had the LECs' network planners been omniscient and able to deploy new technology instantaneously. Were the Commission to attempt to set the charges for interstate access services at "forward-looking" (TSLRIC) levels -- the Commission's "prescriptive" approach⁵ --the LECs would likely fail to recover their full costs from these charges.

11. The Commission's competitive or "market-based" approach would be far preferable to the prescriptive approach because it would allow for the restructuring of access rates into more efficient flat-rate and usage-based components while still allowing the incumbent LECs to recover their interstate costs and allowing the uninterrupted downward pressure on access rates from the Commission's price-cap mechanism and expansion of new competitive local carriers. As these new local carriers develop and expand, either through the construction of new facilities or the leasing of incumbent LECs' network elements, they would be able to provide

most subscribers. The Commission could remedy this deficiency by allowing the LECs to levy a direct charge on those few customers.

⁵ Notice, at 218.

originating and terminating interstate access at rates that reflect their costs. As a result, they could offer customers rates for a bundle of services that reflect these lower costs, placing downward pressure on the incumbent LECs' rates.

12. The market-based approach would not require the abandonment or restructuring of the price-cap regime that has successfully induced LECs to reduce costs and rates over the past six years. If the prescriptive approach to setting interstate access rates on the basis of TSLRIC engineering estimates of these costs is utilized, the Commission would be faced with the possibility of having to return four-square to cost-based regulation. Presumably TSLRIC-based costs will be below today's embedded costs but different from tomorrow's costs. If the Commission were to specify that the loop (CCL) costs or other components of interstate costs currently recovered through switched carrier access charges are to be established at TSLRIC or some other measure of "forward-looking" costs, it would be faced with adjusting these rates at a later date to catch up with further technical change. Such a process would not only vitiate the price-cap mechanism, but it would provide a severe disincentive for future investment by the incumbent LECs in their local networks.

13. Even if the Commission were to set carrier access rates at TSLRIC or some other measure of forward-looking costs on a one-time basis and then to allow all of the restructured components of the current interstate access rates to be governed by a price cap, it would be faced with a major task of adjusting the entire price-cap mechanism for incumbent LECs and finding some other source of embedded-cost recovery for the LECs. Under the price-cap regime now in place, the Commission is not required to determine if the LECs have achieved full recovery of

embedded costs. Indeed, it is this divorce of rate adjustments from actual movements in costs that provides the efficiency-enhancing property of price-caps. But even a one-time adjustment of the price-cap mechanism would involve a return to cost-based regulation and a consequent responsibility on the Commission to assure that rates recover the LECs' full interstate costs.

14. Any attempt to adjust interstate access rates to a measure of costs, even if defended as a one-time adjustment, creates a dangerous precedent that dilutes the efficiency-enhancing effect of the price-cap mechanism. Were such a prescriptive cost-based policy implemented, surely every incumbent LEC would be justified in hesitating to make future new efficient network investments for fear that such investments would trigger new TSLRIC estimates and subsequent price-cap "adjustments" that would deprive it of the benefits of such investments. After all, current estimates of TSLRIC should reflect successful recent investments in local networks that have been induced by the existing price-cap mechanism.

15. Finally, there is an administrative reason to prefer the market-based approach over the prescriptive approach because the latter policy would require not only a set of different exogenous adjustments for each carrier's price cap, but it would require a thorough re-examination of whether price caps could be continued when rates are adjusted to estimates of costs in the regulatory process. The Commission could not assume that the incumbent LECs would maintain their current rate of productivity growth from the starting point of the most optimistic engineering estimates of costs, assuming the immediate implementation of the most efficient technology. A reduction in the productivity offset would be essential at the very least,

and it might even be necessary to scrap price caps altogether if the Commission pursues the prescriptive approach.

Pricing Flexibility

16. Among the many problems of traditional rate regulation, even price-cap regulation, is that regulated carriers are unable to adjust their rates in response to changes in costs or demand. The cost of delivering some services to certain identifiable customers may be much lower than the cost of delivering them to others. In such cases, the carriers and their customers are both better off if they can adjust rates to reflect these differences. Similarly, certain customers may have access to more alternatives to the carrier's services than do other customers. Not allowing the incumbent LECs to respond to competition by reducing rates to some customers could result in the incumbent firms losing customers to less efficient entrants. Regulated carriers may also develop new, innovative services that are substitutes for some current, regulated services. Unless they are allowed to price these services freely in response to market conditions, these new services may not flourish, and customers may be deprived of the benefits of this innovation.

17. The Commission proposes to ease some of its regulations that prohibit local-carrier rate flexibility if the incumbent LEC can demonstrate that it faces potential competition. Specifically, the Commission proposes to ease its prohibitions against geographic deaveraging, volume and term discounts, contract tariffs, and flexible pricing of new innovative access services. The Notice proposes to continue these prohibitions if it finds that "phase 1" potential competition does not exist. The rationale offered for proceeding in this manner is that pricing

flexibility is clearly necessary once the incumbent LECs face potential competition because the absence of such flexibility would risk inviting inefficient entry.⁶ The Notice asserts that allowing such flexibility prior to the appearance of potential competition may allow the incumbent LEC to forestall entry through strategic pricing.⁷ The Commission suggests that once potential competition exists as a result of implementation of the unbundling provisions of the 1996 Telecommunications Act, such strategic pricing is much less likely to succeed because the LECs are required to offer their local services at discounted wholesale rates to any new entrant and to lease all of the unbundled elements of its network to such new entrants at cost-based prices.

18. The Commission correctly identifies the need to allow incumbent LECs greater flexibility in pricing the various access-charge elements. But current limitations on geographical deaveraging, volume and term discounts that reflect cost savings, and contract rates that reflect differences in customer requirements are impediments to efficient pricing regardless of the degree of competition that the incumbent LECs face. Indeed, the Commission admits that some of these prohibitions against pricing flexibility are the source of economic inefficiency.⁸ The only apparent reason for retaining such obviously inefficient restrictions on LEC pricing is the Commission's fear that allowing the incumbent LECs greater rate flexibility might impede future competition.

⁶ Notice at 168.

⁷ See, for example, the Notice at 190.

⁸ Notice at 183 and 190.

19. The Commission's concern that incumbent LECs might use their pricing flexibility in offering access charge elements to foreclose future competition by "locking in" unsuspecting customers ignores some rather fundamental conditions in the market for access services. The customers for these services are not small, uniformed consumers. They are generally large, sophisticated interexchange carriers and business users who are well aware of their options today and tomorrow. Most are participants in the current regulatory process, and virtually all of them are cognizant that they will soon be able to purchase unbundled elements at cost-based rates from the incumbent LECs in every state. These customers are not likely to lock themselves into ill-advised term contracts or other pricing plans that will prove to be unwise as local competition develops in earnest.

20. Nor is there a need to wait for the resolution of universal-service issues and the development of universal-service subsidy mechanisms that are competitively neutral between incumbents and other competitive carriers.⁹ While the Commission should move with dispatch in establishing such a system, there is no need to delay the benefits of more flexible pricing in access until the Commission's universal service plan has been fully implemented.

21. On the other hand, the incumbent LECs must prepare for the full consequences of competition by adjusting their rates towards their costs and developing new services as soon as possible. Geographic deaveraging of access-charge elements, contract pricing for various combinations of these services, and volume and term discounts to reflect the greater certainty in network planning allowed for by longer-term contracts are part of this imperative, as is the need

⁹ Notice at 206.

to price new services without regulatory delays. Because these practices enhance economic efficiency and permit the incumbent LECs to retain those customers that they can serve more efficiently than can their actual or prospective rivals, this additional flexibility should be granted as soon as an interconnection agreement has been approved by a state regulator. Indeed, allowing this flexibility to a carrier constrained by a price cap for all regulated interstate services will induce it to adjust its rate structure to the most socially-efficient level possible given its revenue constraint.¹⁰

22. Once the requirements of the 1996 Act for unbundling, interconnection, and resale are met by the incumbent LECs, the Commission should allow these companies to pursue greater pricing flexibility. Surely, the incumbent LECs should be able to adjust their rates for different traffic volumes or geographical densities as do competitive firms in other industries. Perhaps the most recent example of the pressures of competition on geographic deaveraging of rates is provided by Federal Express's decision to abandon its uniform national pricing strategy by allowing rates to reflect distance. Competitive pressures from other express carriers on the short routes surely contributed to this change in Federal Express pricing, thereby offering more efficient pricing alternatives.

23. Similarly, incumbent LECs should be able to offer their customers various combinations of services under individual contracts and to provide new services at unregulated rates even before full deregulation of interstate access services. New entrants into the provision

¹⁰ See Ingo Vogelsang and John Finsinger, "A Regulatory Adjustment Process for Optimal Pricing by Multiproduct Monopoly Firms," Bell Journal of Economics, Vol. 10, 1979, pp. 157-71.

of interstate access services, using either their own facilities or leased unbundled facilities or both, can offer large telecommunications customers, such as financial-service companies, hotel chains, or transportation companies, a variety of customized packages at unregulated rates. The incumbent LECs should be free to offer similar contract, particularly to large, well-informed buyers, in this more competitive era. This freedom to offer contract rates should allow rates to move closer to the incumbent LECs' costs as they offer services tailored to large customers' individual needs in competition with new entrants into interstate access services. Similarly, the incumbent LECs should be able offer new services, individually or as part of a package, at flexible rates as long as existing regulated services continued to be offered. Such flexibility would provide greater incentive for the incumbent LECs to innovate in developing new services or new combinations of services.

24. Once competition is established, access services should be totally deregulated. The Commission proposes only to liberalize regulation under Phase 2, not to eliminate it, asking for comments on how it might liberalize its price-cap regime to allow the incumbent LECs greater flexibility in establishing their access-charge rate structures. Once competition is present, there is no reason to continue the price-cap regime at all. Regulating the incumbent LECs' access charges while new competitors are free to set their own rates for access services offered through unbundled elements or their own facilities reduces the ability of the LECs to respond promptly to competitors' offerings and rates. It also provides these competitors with the opportunity to use the regulatory process for strategic advantage in an all too familiar manner. Deregulation prevents

this competitive use of the regulatory process and frees the incumbent LECs to compete fully with their rivals.

ESP Exemption and Internet Services

25. In this Notice, the Commission proposes to continue its policy of exempting enhanced service providers (ESPs) from paying access charges on their connections to subscribers. The Commission concludes that it would be burdensome to apply the inefficiently-structured access charges to new, innovative information services.¹¹ Presumably, the more efficient access-charge system that will emerge from this proceeding would be less burdensome to ESPs, particularly Internet service providers (ISPs). Without some usage charge for the lines connecting the ISPs to their customers, ISPs will have little incentive to use services and technologies that lessen the load on the traffic-sensitive portion of the current switched network or to divert Internet traffic from the circuit-switched local network to more efficient packet-switched networks.

26. The Commission should recognize that the current federal/state system of regulating the rates for residential and business lines generally results in rates that are not aligned with cost causation and that the divergence between these rates and costs is exacerbated by the use of these flat-rate lines to originate or terminate ESP services. This problem has become particularly acute for the business lines that the ISPs use to connect their subscribers. As the Commission notes,¹² these business lines are typically priced at a flat monthly rate or at a rate

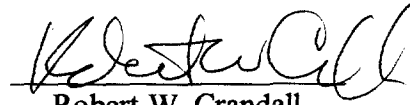
¹¹ Notice at 288.

¹² Notice at 285.

that does not vary with the number of minutes of incoming local calls. As a result, ISPs price their services at flat monthly rates, providing residential Internet subscribers with the incentive to remain connected to their ISP for long periods of time even if the value to the subscriber of the connection is very low. Because the ISP and its subscribers are not charged for the cost of tying up the LEC switch, the ISP it has no incentive to charge its customers for this cost. The LEC business lines subscribed to by ISPs are therefore used as much as eight times as intensively as the average business line, resulting in additional burdens on the LECs' switching and trunking capacities that are not reflected in their rates and revenues.

27. An obvious solution to the problems of intense usage of access lines by ESPs and their customers is some form of usage-sensitive pricing to reflect the cost imposed on the LECs' switching capacity. Such charges might, in turn, lead the ESPs to seek new packet-switched services to connect with their customers. However, if they are allowed to continue to use flat-rate access lines at rates that are based on much lower average peak-hour usage, they will have no incentive to seek alternative, more efficient ways of serving their customers. Therefore, the Commission should consider some mechanism for lifting the ESP exemption and subjecting ESPs to a usage-based charge.

I hereby swear, under penalty of perjury, that the foregoing is true and correct to the best of my knowledge and belief.


Robert W. Crandall

Subscribed and sworn before me this 22ND day of January, 1997.

My Commission expires Union Empire October 1, 1993


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